Moscow Financial Weekly

For the week ending December 19, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Banking system assets up by 55% since 1998
- Mandatory reserve requirements to be lowered
- S&P downgrades YUKOS

Key Economic Indicators

Indicators	Level	chg 1 week	chg since Jan. 1	chg 12 months
RUB/USD (MICEX) UTS (changes in %)	RUB 29.2505	0.69	7.97	8.17
RUB/EUR (changes in %)	RUB 36.2965	-1.20	-9.09	-11.11
Monetary Base* (changes in %)	RUB 1239.6 bln	3.95	37.03	48.98
CPI	NA	NA	11.3	NA
International Reserves* (billions)	USD 71.8	USD 1.2	USD 24.1	24.0
RTS Index (changes in %)	569.59	5.28	58.63	64.41
Urals Crude (changes in %)	USD 29.42	6.9	-2.94	14.25
JPMorgan EMBI+ RUS spread (changes in bp)	263	-2	-215	-190
CBR Time Deposits (changes in bp)	1.5%	94**	560	

*For one week prior

Economic Developments

Industrial production data through November was released this week. **Growth in industrial production** totaled 7.1% y-o-y in November, and was up by 6.8% during the first 11 months of the year. Once again growth was highest in the extraction industries -- the non-ferrous metals industry was up by 13% in November and the fuel industry grew by 8.2%. The food processing industry was up by 4.9%, production of construction materials rose by 8.6% and the machinery sector grew 10.9%. These are the industries where the growth is fueled by numerous, ongoing capital investments. The growth in industrial production is once again attributable to high natural resource prices this year.

Industry	October 2003	January-November 2003
Fuel	8.2	9.4
Ferrous metals	6.5	8.9
Machinery	10.9	8.5
Non-ferrous metals	13	6.1
Glass	5.6	6.0
Construction materials	8.6	5.7
Food processing	4.9	5
Chemical	7.6	3.9
Electricity	-0.5	2.5
Medical	-12.5	2.5
Forest	2.9	1.2
Light	0.1	-2.5
Polygraph	12	-3.7
Microbiology	-3.6	-18.8

*Goskomstat

The rating agency Fitch has announced that there is a possibility that **Russia's sovereign rating** would be increased to investment grade in the middle of next year. The last time Fitch increased the rating was in May, when it gave Russia BB+, which is one step lower than investment grade. After Moody's increased Russia's sovereign rating to investment grade last October, the other two agencies (Fitch and S&P) did not directly comment about the possibility of following suit, noting only that each rating agency has its own methodology for determining its ratings. However, after the December elections, when it became clear that the new Duma will contain a clear majority of pro-presidential deputies, Fitch apparently made the judgment that it will now be easier to implement economic reforms in Russia. However, S&P is not as optimistic, and accordingly has not made any estimation of when its rating for Russia might be changed. Last week, it said that it is in the process of evaluating Russia, but noted that, despite political stability, Russia still has high political risk arising from the lack of transparency in decision-making by the authorities. Also, the agency noted the tight link between Russian growth and the prices of natural resources. The last time S&P increased Russia's sovereign rating was one year ago, when it rose to "BB" -- two steps below investment grade.

	S&P	Moody's	Fitch
Investment Ratings	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	**Baa3***	BBB-
Speculative ratings	BB+	Ba1	**BB+***
	BB*	Ba2	BB
	BB-	Ba3	BB-

*Russia's current ratings

Banking sector

The EBRD plans to enter into formal negotiations with the GOR regarding the purchase of a stake in **Vneshtorgbank** (VTB) by the end of January 2004. According to its statement, the EBRD is quite pleased with the level of cooperation VTB management has been demonstrating so far. Originally, the GOR, which owns 99.9% of VTB, expected that the EBRD would become a VTB shareholder by the end of this year. However, a few days ago, Prime Minister Kasyanov, during an official visit to Japan, said that the EBRD would enter into the capital of VTB during the first half of 2004. During the second half of 2004, Kasyanov continued, smaller stakes might be offered to other potential shareholders. Kasyanov also questioned the need for the planned 7-year convertible loan from the IFC. JP Morgan and Ernst & Young, who have been asked by the GOR to assess the value of VTB, reportedly produced a figure slightly higher than $3 billion. Before the assessment was completed, the EBRD offered $200 million for 10% of VTB. Now the GOR wants $300 million for the stake.

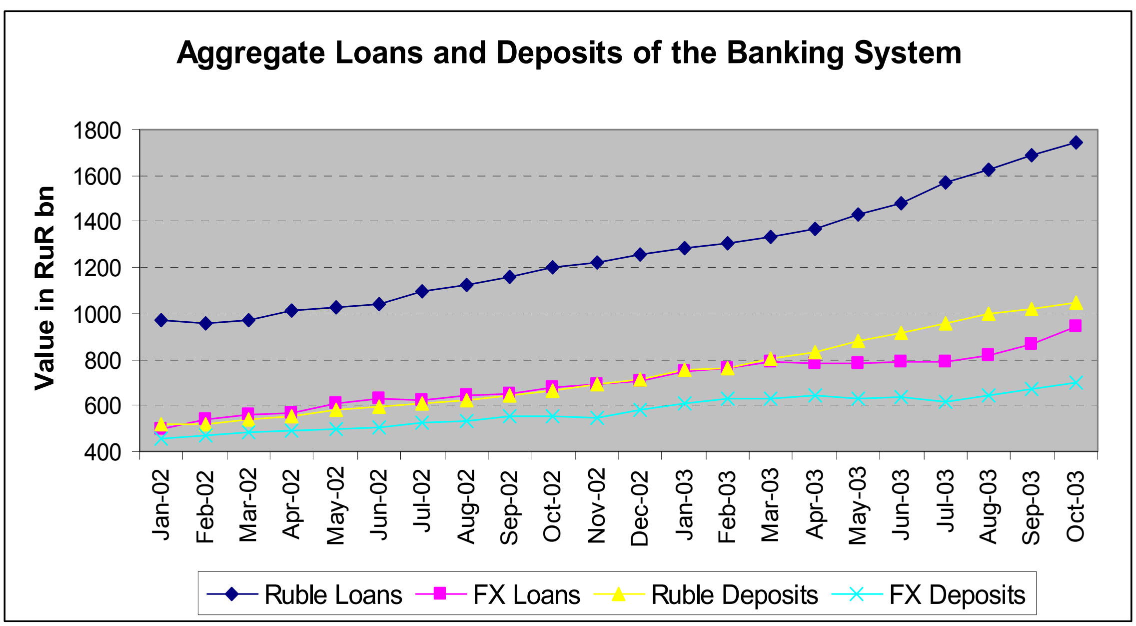
On December 19 Oleg Vyugin, CBR First Deputy Chairman, rendered an account of the **monetary policy** implemented by the Bank and the Ministry of Finance in 2003. Vyugin estimates that real appreciation of the ruble against a basket of currencies for the year will reach 5%, while real appreciation of the ruble against the USD will be 20%. The ruble could be stronger and Russian assets could be valued higher than they are, Vyugin noted, adding that fast growth of foreign reserves is evidence that “the situation is imbalanced” (i.e. the CBR restrains ruble firming).

The CBR does not plan to change the structure of **foreign reserves**, Oleg Vyugin said. He specified that 65-70% of reserves is denominated in USD and 25-30% in Euros. Current fluctuations of exchange rates do not matter for long run strategy, Vyugin stressed.

The CBR plans to reduce the **mandatory provisioning** norm in the first quarter of 2004, according to Vyugin. However, he said the reduction would be very small. He also stressed the importance of reducing provisioning requirements gradually, so it does not boost inflation. According to Vyugin, reduction of the norms by 1% adds RUB 20 billion liquidity, far less than the current liquidity of the banking system; so gradual movements cannot lead to qualitative changes. At present, reserve requirements range from 7% to 10% of the bank account balances. The Russian banking community (especially the Association of Regional Banks) has been demanding a cut in mandatory provisioning requirements for a long time.

On December 19 RBC business news agency reported that the GOR instructed Minfin and VEB to take urgent measures “to protect the interests of the state”. The case in point is USD 115.5 million of budget funds paid at the end of the Soviet era by VEB to London-based **Moscow Narodny Bank** (MNB). These funds were lent to MNB through VEB to cover the debt of two Liberian shipbuilders. According to the Accounting Chamber, commissioned by the National Banking Council to examine relations of the CBR with the foreign banks where it has a controlling stake (MNB, BCEN-Eurobank and Ost-West Handelsbank), MNB has never transferred the claims to VEB or Minfin, nor has it repaid the money. The Accounting Chamber suggested in a letter to Finance Minister Kudrin that the sum should be collected from MNB to the budget. The GOR wants the money collected by the end of the year (or even by December 25). In addition, as we reported in June, VTB sued MNB for USD 104.3 million and has already won in the court of first instance. The CBR planned to sell MNB, but now, Oleg Vyugin commented, there are two options: to withdraw the money immediately and shut down the bank as it would be bankrupt, or sell the bank and recover the sum from the proceeds. If MNB is forced into bankruptcy, it would probably ruin the plans to merge its Russian daughter, Mosnarbank, with Eurofinance.

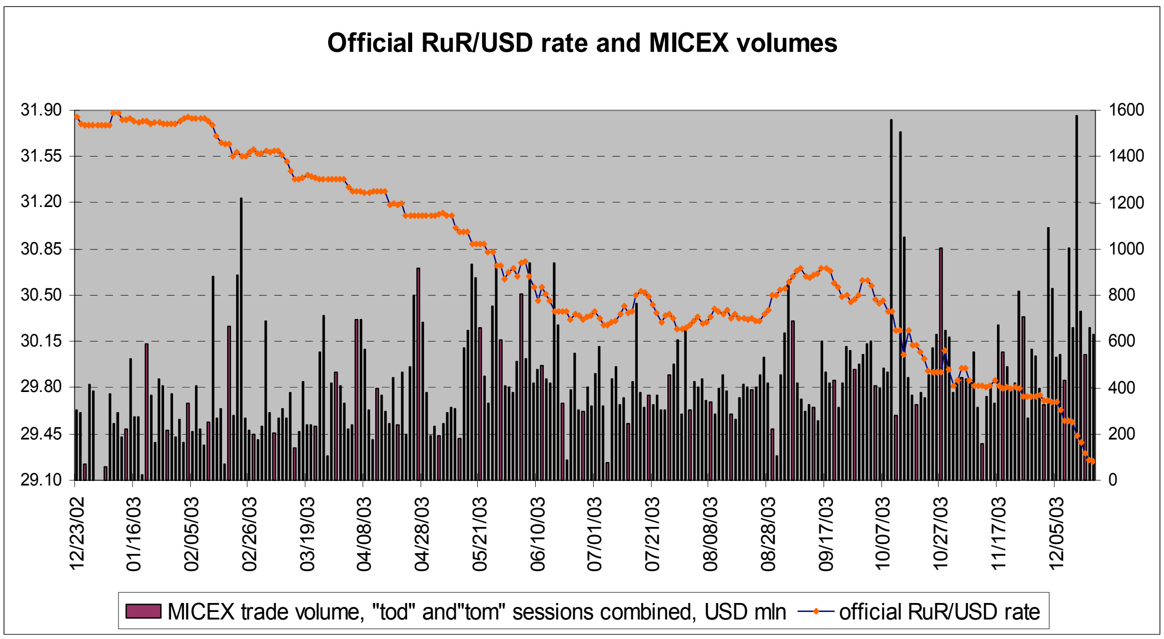
According to the CBR, 1,232 **credit institutions** (92.77% of the 1,328 currently in operation that submitted the required accounts to the CBR) finished the first ten months of 2003 with profits totaling RUB 110.97 billion, while 96 credit institutions (7.23%) had losses totaling RUB 664.3 million. Another five operational credit institutions failed to provide the CBR with the required accounts by November 1. The aggregate assets of the Russian banking system went from RUB 766.1 billion on July 1, 1998, to RUB 3160 billion on January 1, 2002, to RUB 4145 billion on January 1, 2003 and to RUB 5351 billion on November 1, 2003. In real terms, total assets increased between July 1, 1998 and November 1, 2003 by 55.4%. Aggregate equity capital went up from RUB 116.3 billion on July 1, 1998, to RUB 453.9 billion on January 1, 2002, to RUB 581.3 billion on January 1, 2003 and to RUB 789.3 billion on November 1, 2003. In real terms, aggregate capital increased between July 1, 1998 and November 1, 2003 by 55.8%.



Financial markets

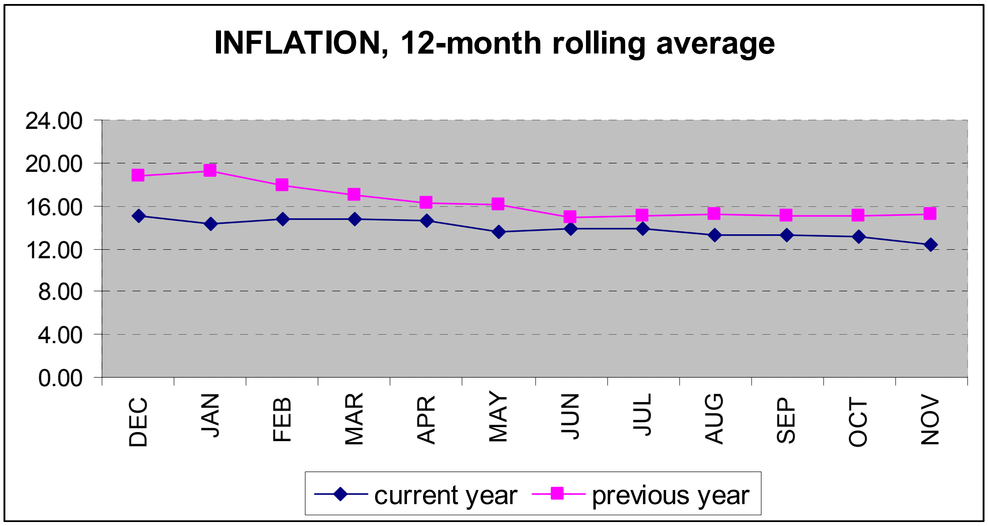
Forex Market

The ruble began the week firming against the dollar at the same pace as in the previous week, but in mid-week slowed down and by Friday afternoon even backed off, losing a couple of kopeks in trading. This happened after a "verbal intervention" by Oleg Vyugin, who said that the CBR would continue supporting the dollar and that the exchange rate should not significantly change until the end of the year. Interestingly, retail dollar sales resulted in a cash dollar that was about 1-2% cheaper at exchange points than in the interbank market and at MICEX.



Prices

According to Prime Minister Kasyanov, the inflation rate for the first two weeks of December was 0.5%, and if this remains constant through the rest of the month, then annual inflation would equal exactly 12%, which is the government's target for the year. Traditionally, inflation during the last two months of the year is higher due to seasonal factors, mainly holiday-related spending: however, this year there is no such tendency, possibly because of the sharp and accelerating decline of the dollar vs. the ruble. This makes it possible for the government to meet its target for the first time since 1997. The seasonal accelerated government spending in December is usually reflected in inflation statistics for January, when monthly inflation is traditionally the highest in the year.

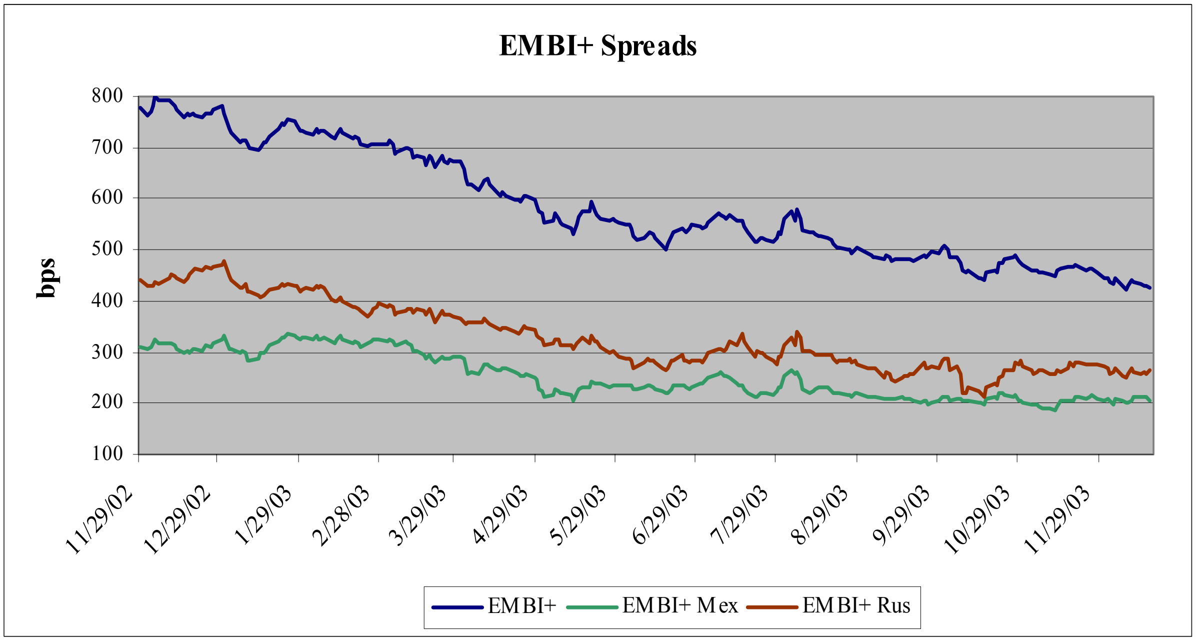


<u>Eurobonds</u>

Last week, JP Morgan announced an increase in the proportion of Russian Eurobonds in its base portfolio from which the JPMorgan EMBI+ is calculated. Approximately six weeks ago, JP Morgan had reduced the weight of Russian paper in this base portfolio. Currently, Russia's percentage in the JPMorgan EMBI+ and EMBI Global is approximately 20%. The percent of each country in the index depends on the market value of its debt.

Prices of almost all Russian Eurobonds increased last week, supported by the news from JP Morgan as well as from rising prices of Eurobonds from other emerging markets such as Turkey, which rose to record highs last week.

COMPONENT	COMPONENT SPREAD & DATE				SOVEREIGN RATING		
JPMorgan's	12/18/03	12/12/03	11/21/03	12/31/02	S&P	Moody's	Fitch
EMBI+	427	438	467	765	N/A	N/A	N/A
EMBI Brazil	473	501	559	1460	B+	B2	B+
EMBI Mexico	208	214	212	329	BBB-	Baa2	BBB-
EMBI Russia	264	261	279	478	BB	Baa3	BB+
EMBI Turkey	309	331	395	696	B+	B1	B



Interest/Bond Market

Bonds/Bills

The rating agency S&P has lowered the long-term credit rating of YUKOS by one point down to "BB-", due to the continued political risks of the company. The forecast is still negative, which implies the possibility of lowering the rating again. However, lowering of the rating didn't affect YUKOS shares, as the political risk is assumed to be already included in the share price.

Gazprom plans to proceed with an issuance of 3-year ruble bonds, for a total of RUB 10 billion (USD 340 million) and a coupon rate of 8.11%. The decision is to be made on the BoD meeting on December 25. The company had planned this issuance for September, but at that time market yields were too high and the company decided to wait for more favorable conditions.

The Finance Ministry made an additional placement of OFZ issue number 46001, maturing in 2008, with a total sum of R1.988 billion and an average yield of 8.17% -- a small premium over current market yields. At the same time, the Ministry has paid out coupons on four OFZ issues, for a total sum of R1.79 billion.

The auction of new government debt had practically no effect on the secondary OFZ/GKO market. Yields rose on rather moderate activity. Due to the very low yields, mainly large institutions are currently active in the market, while the smaller participants prefer to stay on the sidelines.

Overnight rates

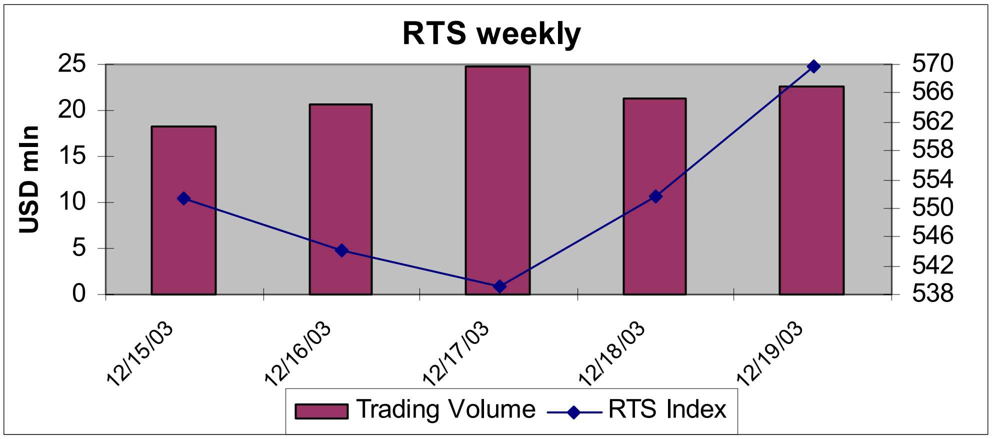
Ruble liquidity continued to be very high last week, with balances on banks' correspondent accounts rising as high as R210.9 billion by the end of the week, and depressing short ruble interbank rates down to 0.99-1.36% p.a. for the MIACR overnight. The current levels of balances as well as banks' deposits in the CBR are at record high levels.

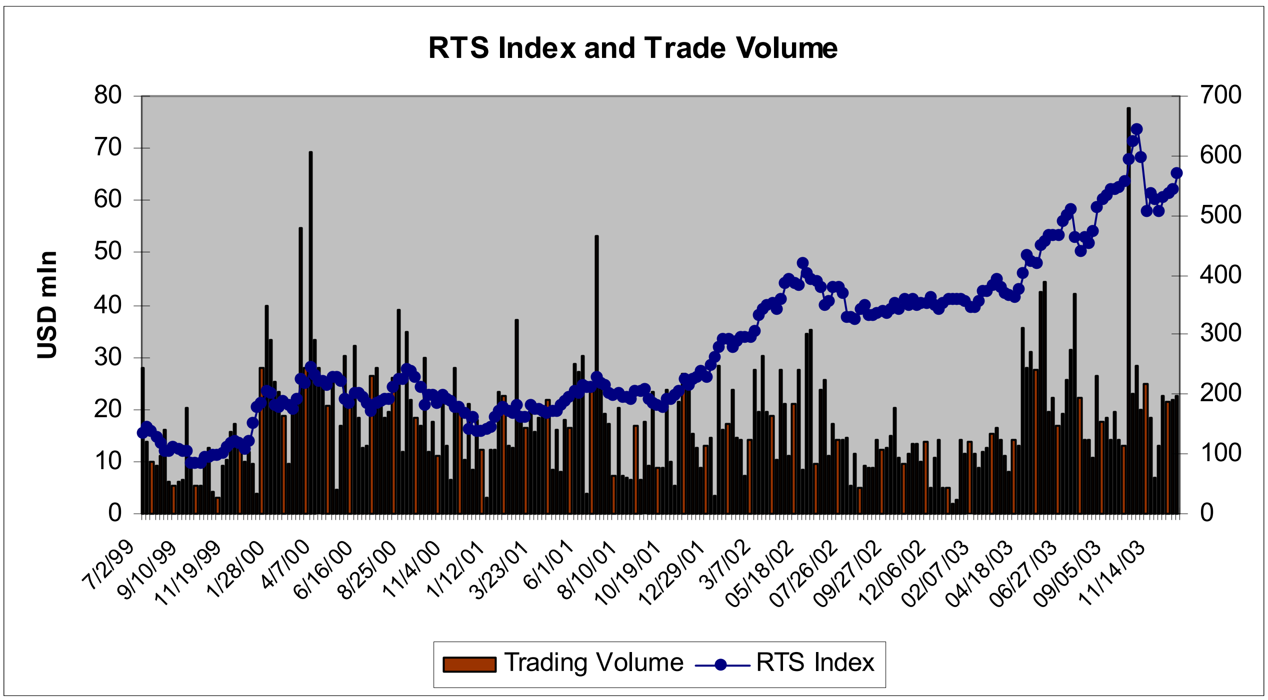
Stock Market

The two biggest Russian machinery building companies -- Unified Machinery plants and Power Machines -- have announced plans to merge. The merger is expected to be complete by fall next year. The new company will concentrate on production and marketing of energy machinery, including machinery for nuclear power stations. The synergy of the two companies will allow substantially lower transaction and administrative costs, and will make the new company one of the leaders in the energy equipment sector. The new firm's consolidated revenues are expected to be more than $1 billion. In addition, the merged company is expected to have easier access to the capital markets, with lower associated costs. Currently, Unified Machinery Plants has capitalization of $228 million and Power Machines -- $258 million, which has made it problematic for the companies to raise capital through the stock market.

A Delaware court has approved Severstal as the buyer of the bankrupt U.S. Rouge Industries. Severstal paid $285.5 million, which is considered to be an attractive price for the Rouge Industries assets. The purchase gives Severstal access to the U.S. market, in keeping with the company's strategic plan to increase sales in the U.S. market, access to which so far has been limited by import tariffs.

Last week, the Russian shares showed a positive dynamic. YUKOS shares, after a prolonged period of being out of favor, were one of the leaders of the increase, up by approximately 13% for the week. Sibneft was not far behind - up 11.5% for the week. However, the big winner was Unified Machinery Plants, whose shares rose by 20% for the week. The RTS index pierced through an important psychological level of 565 last week, stopping at 569. The index increased 5.28% for the week on slightly lowered volumes. This can be partially explained by lower trading activity ahead of the prolonged holiday season.

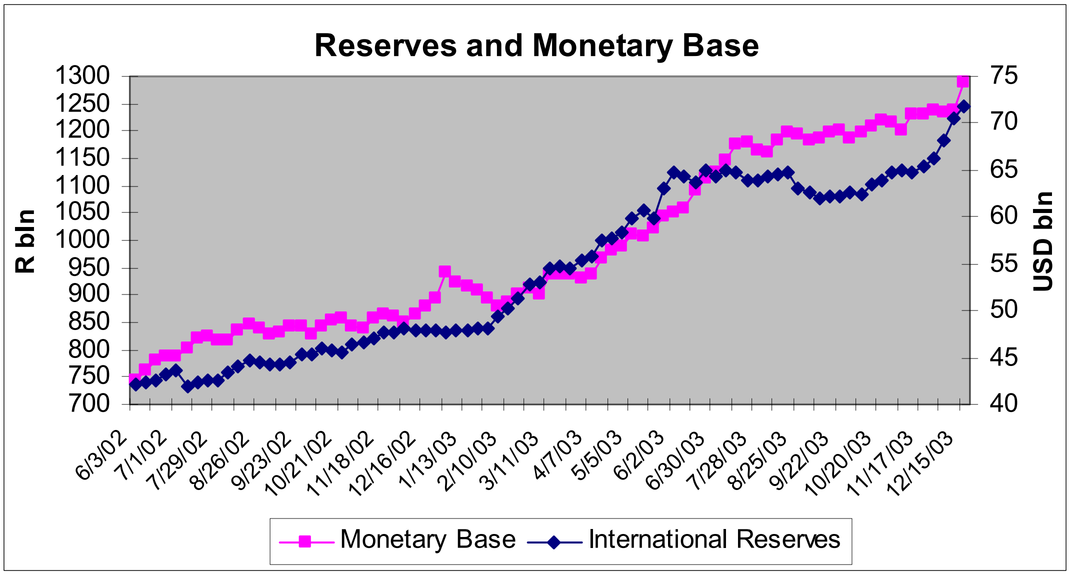




International Reserves and Monetary Base

International reserves of the CBR and the Finance Ministry stood at USD71.8 billion as of December 12, which is USD24.1 billion or 50.52% higher than at the beginning of the year. Despite the increased capital outflow caused by the arrest of Mikhail Khodorkovskiy, reserves continue to rise on increasing oil prices: the average Urals price has been slightly higher than USD28/bbl since the beginning of October.

The monetary base continued to rise for the second week in a row and was up by as much as R48.9 billion (3.95%), totaling RUB 1,288.5 billion as of December 15.


Reserves and Monetary Base
R bln
USD bln
1300
1250
1200
1150
1100
1050
1000
950
900
850
800
750
700
75
70
65
60
55
50
45
40
6/3/02
7/1/02
7/29/02
8/26/02
9/23/02
10/21/02
11/18/02
12/16/02
1/13/03
2/10/03
3/11/03
4/7/03
5/5/03
6/2/03
6/30/03
7/28/03
8/25/03
9/22/03
10/20/03
11/17/03
12/15/03
Monetary Base
International Reserves

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell repatriated currency. Minimum lot size for each of the dollar instruments is USD100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. **INTEREST RATES**: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. **STOCK INDICES**: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. **INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION** represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. **MONETARY BASE** (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.

7. **JPMORGAN EMERGING MARKETS BOND INDEX PLUS** (EMBI+) tracks total returns for traded external debt instruments in the emerging markets. The instruments include external-currency-denominated Brady bonds, loans and Eurobonds, as well as U.S. dollar local markets instruments. The EMBI+ may be separated into individual components (such as by sovereign issuer). The source of all EMBI+ data in this publication is JPMorgan.